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Special Allocations within Partnerships: A Comprehensive Test for Substantial Economic Effect

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SPECIAL ALLOCATIONS WITHIN PARTNERSHIPS: A COMPREHENSIVE TEST FOR "SUBSTANTIAL" ECONOMIC EFFECT

*by Joe Foran**

The partnership provisions found in subchapter K of the 1954 Internal Revenue Code are supposedly designed to be flexible, simple, and equitable.[1] Toward this end section 704(a) permits partners to determine by simple agreement their distributive shares of partnership income and loss.[2] This privilege is particularly valuable to partners because the partnership itself is not a taxable entity but serves merely as the conduit through which its income, deductions, and losses flow to the individual partners.[3] Thus, a partner may receive for tax purposes either a general allocation of profits and losses from a predetermined formula or a special allocation of specific items of income and loss.[4] These allocations enable partners to distribute more equitably partnership revenues and expenses in accordance with each partner's relative independent interests and participation in the partnership and permit partners to fashion more easily the flexible financial arrangements necessary to conduct a modern business.

Prior to the Tax Reform Act of 1976[5] a section 704(a) allocation was conditioned only upon section 704(b)(2), which invalidated an allocation whenever its "principal purpose was deemed to be tax avoidance or evasion."[6] The validity of a partnership's allocation is now conditioned not only upon the other tax provisions in subchapter K,[7] but also upon the particular partnership provision having "substantial economic effect" considering all the relevant facts and circumstances.[8] Thus, to determine the validity of a

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1. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4091; S. REP. NO. 1622, 83d Cong., 2d Sess. 89, *reprinted in* [1954] U.S.CODE CONG. & AD. NEWS 4621, 4722.

2. I.R.C. § 704(a): "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement." *But see* note 6 *infra* and accompanying text.

3. I.R.C. § 704; United States v. Basye, 410 U.S. 441, 448 (1973).

4. I.R.C. § 704. Partnership tax provisions also apply to syndicates, groups, pools, and joint ventures. *Id.* § 761(a); A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 195 (1968). Special allocations most commonly occur where one partner contributes expertise and services—assets which have no income tax basis—and the other partners contribute money or other valued assets. *See generally* 1 A. WILLIS, PARTNERSHIP TAXATION § 25.12 (2d ed. 1976).

5. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

6. I.R.C. § 704(b)(2). The disallowance of one allocation does not, however, threaten other allocation agreements because the validity of each special allocation is independently determined. Any disallowed item is distributed according to the general partnership distribution agreement or the partner's respective interests in the partnership. *Id.*

7. Section 704(a) relating to the effect of other provisions was amended to read "except as otherwise provided in this *chapter*." Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 90 Stat. 1548 (emphasis added).

8. *Id.* The test of substantial economic effect was probably not codified earlier because the drafters of the revisions to the various partnership provisions believed its inclusion would create additional statutory interpretation difficulties. *See* Driscoll, *Tax Problems of Partnerships—Special Allocation of Specific Items*, U. SO. CAL. 1958 TAX INST. 421, 426 n.14. But even before the amendments no court had ever determined the validity of an allocation using any

special allocation the present Code sets out a dual test which requires "both a bona fide business purpose and a lack of any significant tax avoidance,"[9] and which means simply that a special allocation must have business validity independent of its tax consequences.

The concept of substantial economic effect lacks clear definition. An absence of legislative history[10] and consistent judicial construction[11] has slurred its meaning. In addition, this amorphous touchstone for a special allocation is both overly narrow and unduly broad because in assessing the validity of a particular partnership provision under section 704 the concept ignores relevant tax considerations[12] yet acts as the sole statutory test for many different kinds of business arrangements. Since the government and the taxpayer need a comprehensive standard that will accurately and conclusively measure the appropriateness of a special allocation, this Comment studies the present test and offers some criteria for judging an allocation question. More specifically, it seeks to synthesize congressional action, the case law, and the principal commentaries into an ordered inquiry designed to discover whether the effect of a section 704 allocation complies with its legislative purposes, and whether the allocation itself conforms to the general taxing scheme within subchapter K of the 1954 Code.

After tracing the development of the special allocation privilege and studying previous interpretations of the "substantial economic effect test," this Comment proposes an ordered approach to deciding the issues of special allocations. Called the "reasonable risk test," this new structured approach should explain the present significance of the substantial economic effect requirement as well as offer the courts more thorough means of balancing, as the Code intended, all the competing interests in a partnership tax case.[13] Finally, the reasonable risk test is applied to current partnership tax controversies in order to demonstrate the test's utility.

I. The Origins of Substantial Economic Effect

The concept of substantial economic effect had an unusually esoteric origin. It first appeared in tax law in the 1954 Code revisions, and the Regulations continue to define it as "whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income independently of the tax consequences."[14] This definition, however, inadequately explains the concept's significance or meaning. Therefore, this section studies the legislative and judicial history of the substantial economic effect requirement in order to explain more thoroughly that concept's present import.

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other test. Wolfen & Fossum, *Partnership Elections and Special Allocations*, U. So. Cal. 1973 Tax Inst. 385, 413 & n.83.

9. House Comm. on Ways and Means, Tax Reform Act of 1976, H.R. Doc. No. 658, 94th Cong., 1st Sess. 125-26 (1975). *See also* Prentice-Hall, Tax Reform Act of 1976, No. 202b, ¶ 813, at 666 (1976).

10. *See* notes 27-39 *infra* and accompanying text.

11. *See* notes 40-91 *infra* and accompanying text.

12. *See* notes 14-26 *infra* and accompanying text.

13. 1 A. Willis, *supra* note 4, §§ 25.01-.03.

14. Treas. Reg. § 1.704-1(b)(2) (1964).

A. *Legislative History*

Mark H. Johnson, writing with Jacob Rabkin in 1942, noted the uncertainties in the then existing law of partnership taxation.[15] Their findings stimulated professional groups to agitate for improvement in the 1939 Code.[16] Shortly after the Johnson-Rabkin article was published, two such groups, the American Law Institute and the ABA Committee on Partnership Taxation,[17] began work on the income tax project that ultimately spawned subchapter K of the 1954 Code.[18]

Within this subchapter the pivotal provision for determining each partner's taxable income and reducing uncertainty of partnership tax consequences is section 704. The theory of section 704 is that self-interests will cause partners to attribute income, gain, loss, deductions, or credits only to the partner who deserves them, even though a different formula may be applied to each of these items.[19] Moreover, these formulas may be predetermined ratios or special allocations of specific items.[20] Thus, although the Code basically relies on the partners to police themselves, the Code nevertheless retains the power to disallow these allocations if their principal purpose is tax avoidance. In that instance the allocation lacks the requisite substantial economic effect.[21]

Under previous codes all items of partnership income and loss had to be divided pro rata among the several partners,[22] with the following exceptions: (1) partners could elect to distribute profits differently than losses;[23] (2) the loss from a specific event could be allocated to a partner if he had guaranteed the other partners against that loss;[24] and (3) income from foreign sources could be specially allocated under the theory that the organization was really a sharing arrangement between two different partnerships.[25] Other than these well-circumscribed exceptions, the courts refused to allow special allocations within a partnership until the adoption of the 1954 Code.[26] Thus, section 704 represented a major innovation in partnership tax law by allowing partners to deviate from a strict uniform rule of apportionment in determining their distributive shares. The resulting flexibility permitted the creation of new financial arrangements that better matched the needs of the partners against the needs of the market place. This occurred, theoretically,

15. Rabkin & Johnson, *The Partnership Under the Federal Tax Law*, 55 HARV. L. REV. 909 (1942).
16. 1 A. WILLIS, *supra* note 4, § 3.02.
17. Mr. Johnson also chaired the Committee on Partnership Taxation and is appropriately regarded as the father of subchapter K.
18. 1 A. WILLIS, *supra* note 4, § 3.02.
19. A. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION § 1.04 (1971).
20. I.R.C. § 704; *see* note 4 *supra* and accompanying text.
21. Treas. Reg. § 1.704-1(b)(2) (1964); *see* notes 66-90 *infra* and accompanying text. "Substantial economic effect" was originally intended only to amplify the tax avoidance test found in section 704 and in other sections of the Code. For an explanation of why the substantial economic effect test was not included in the statutory language of § 704 until now see Driscoll, *supra* note 8, at 426 n.14.
22. O.D. 140, 1 C.B. 174 (1919). *See also* Charles C. Ruprecht, 16 B.T.A. 919, *acq. in*, VIII-2 C.B. 46 (1929), *aff'd*, 39 F.2d 458 (5th Cir. 1930).
23. I.T. 1849, II-2 C.B. 6 (1923).
24. Lederer v. Parrish, 16 F.2d 928 (3d Cir. 1927); John G. Curtis, 12 T.C. 810 (1949), *aff'd*, 183 F.2d 7 (7th Cir. 1950).
25. G.C.M. 17255, XV-2 C.B. 243 (1936). *See generally* Driscoll, *supra* note 8, at 423-24.
26. Rev. Rul. 134, 1956-1 C.B. 649. *But see* Rev. Rul. 138, 1957-1 C.B. 543.

because special allocations enabled the money partners to be compensated for their venture capital commensurate to the compensation the service partners received for their expertise.

Also in contrast to previous Codes, extensive explanations and regulations accompanied the 1954 Code; but surprisingly, the immensely potent provisions of section 704 were barely discussed.[27] In fact, neither the American Law Institute's draft of subchapter K nor the related comments discussed the possibility of special allocations of specific items of partnership income, loss, or deductions except in situations involving contributed property or transfers of a partnership interest.[28] The Ways and Means Committee similarly failed to indicate its understanding of the allocation privilege in section 704 even though it was the committee that was responsible for greatly expanding the scope of the allocation privilege.[29] The committee's failure to explain its reasoning for enlarging the scope of the privilege leaves a large gap in the legislative history of section 704, and causes the report of the Senate Finance Committee to appear as the only significant congressional study of the purposes, problems, and implications of section 704 prior to its final adoption.[30]

But in any legislative history of section 704(b) this Senate report would have played a significant role because the report's findings represented the views of the tax-writing committee of the Senate, were promulgated after House action on the bill, were not questioned by the House members of the Joint Conference Committee, and evidenced thorough research into the problem.[31] In addition, the Senate Finance Committee first explained[32] the import of the allocation privilege and its limitations through examples and relevant circumstances, the most important of which was the substantial economic effect test.[33] Those illustrations and tests plainly conveyed the committee's attitude towards allocation: Partners may specially allocate, even though the allocations reduce their aggregate tax liability, so long as a special allocation is not merely a device to reduce the taxes of certain partners without actually affecting their shares of partnership income. Notably, not only did the Treasury Department later incorporate this report into

27. *See* Driscoll, *supra* note 8, at 424. *See also* 1 A. WILLIS, *supra* note 4, § 25.02.
28. 1 A. WILLIS, *supra* note 4, § 25.02; H.R. REP. NO. 1337, *supra* note 1, at 65.
29. *See* Driscoll, *supra* note 8, at 425-28; S. REP. NO. 1622, *supra* note 1, at 379.
30. *See* S. REP. NO. 1622, *supra* note 1, at 379. *See generally* Comment, *Partnership Taxation: The Allocation of Specific Items of Income and Loss Under the 1954 Code*, 20 Sw. L.J. 840 (1966). Even the Tax Reform Act of 1976 failed to discuss very extensively the underlying concept of partnership allocation or the tests for determining their validity upon which countless taxpayers rely in making their investment decisions. The courts have been left to fashion definitions on a potentially chaotic and inconsistent ad hoc basis.
31. *See* Driscoll, *supra* note 8, at 427-28.
32. S. REP. NO. 1622, *supra* note 1, at 379.
33. According to the Regulations, besides having substantial economic effect, the other "relevant circumstances" to a special allocation include:

> Whether the partnership or a partner has a business purpose for the allocation; . . . whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated items could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation.

Treas. Reg. § 1.704-(b)(2) (1964). But for a discussion of the relative insignificance of these other circumstances see Wolfen & Fossum, *supra* note 8, at 413 & n.83.

its Regulations,[34] but Congress ultimately adopted sections 704(a) and (b), having made only minor technical changes from its initial version of this potent partnership tax provision.[35]

Pervasive throughout the Senate Report and subsequent amendments to the Code was that substantial economic effect is the most relevant circumstance in a decision whether a special allocation has as its principal purpose tax avoidance. Yet its true meaning remains unexplained. The Regulations merely state that special allocation has the requisite substantial economic effect if it is an "allocation that *may* affect the dollar amount of the partner's distributive share of total partnership income or loss independently of the tax consequences."[36] Furthermore, even though the courts and previous Congresses have adopted the view that a special allocation is invalid unless it has substantial economic effect, they have failed to add any precision to its definition except to tack on the requirement that a section 704 allocation have a bona fide business purpose too.[37] Nevertheless, substantial economic effect has become the unassailable prerequisite to a special allocation. Thus, while tax practitioners were not surprised by the decision of Congress to codify the substantial economic effect test as a test for special allocations, they were disappointed that Congress neglected the opportunity in the new Tax Reform Act to explain more precisely the meaning of substantial economic effect.

Tax practitioners were also disappointed by the fact that rather than discussing this new test, Congress merely stated that the new test "is intended to incorporate all of the factors currently taken into account in testing an allocation under present law."[38] As a result, tax practitioners and the courts are forced to sort through the same cases and rulings that arose under pre-1976 regulations to discover the true meaning of substantial economic effect. The only major controversy the Tax Reform Act did resolve in this area was that overall allocations of taxable partnership income or loss are permissible in addition to item allocations, provided such allocations have substantial economic effect. At the same time, the Act creates a new area of dispute over what interests a partner has in the partnership on which to base his allocation. Evidently, a partner's interest is not determined solely by his investment but by all the facts and circum-

34. *Compare* Treas. Reg. § 1.704-1 (1964), *with* S. REP. NO. 1622, *supra* note 1, at 379.

35. 1 A. WILLIS, *supra* note 4, §§ 25.02-.03.

36. Treas. Reg. § 1.704-1(b)(2) (1964). Notably the Regulations do not require the allocation actually to affect the dollars; the test is whether "the allocations *may* actually affect the dollars." *Id.* (emphasis added). Yet the Service remains very sensitive to special allocations and scrutinizes partnership returns very closely for any discrepancies or irregularities in distribution of a partnership's income, credits, dividends, interest, and contributions. 1 A. WILLIS, *supra* note 4, § 25.03.

37. 2 A. WILLIS, *supra* note 4, § 68.08. *See also* Leon A. Harris, Jr., 61 T.C. 770 (1974). *See also* HOUSE COMM. ON WAYS AND MEANS, *supra* note 9, at 125-26. For a discussion of the possible effects of imposing a "business purpose" doctrine upon partnerships for income tax purposes see 1 A. WILLIS, *supra* note 4, §§ 1.02-.03, 1.07, 5.02, 25.17. *See also* Cowan, *Partnerships—Distributive Shares—Disallowance of Special Allocations*, BNA TAX MANAGEMENT PORTFOLIO NO. 283, at A-1-2, A-5-10 (1973).

38. HOUSE COMM. ON WAYS AND MEANS, *supra* note 9, at 124-27. Congress expressly warned anyone against drawing any "inferences as to the propriety or impropriety of any special allocations under [previous] law." *Id.* This warning probably represents additional evidence that Congress did not intend the new codification to cause any substantive change in the test for special allocations.

stances, including "interests of the respective partners in profits and losses (if different from that of taxable income or loss), in cash flow; and in their rights to distributions of capital upon liquidation."[39] Consequently, to establish the validity of a special allocation the taxpayer probably must show first that the allocation has substantial economic effect, and second that the allocation was made in accordance with that partner's interests in the partnership. Although both terms lack definition, this Comment is limited to discussing the meaning of the first term: substantial economic effect.

B. *Judicial Evolution*

Infrequent litigation on the issue of special allocations has prevented courts and commentators from delineating the meaning of substantial economic effect even though everyone agrees that it is essential to a valid allocation.[40] Moreover, the Service has recently refused to issue advance rulings or determination letters indicating whether an allocation has the requisite economic effect or even whether the principal purpose of a special allocation is tax avoidance or evasion under section 704.[41] As a result of this practice and the amorphous state of the law on the point, practitioners have few guideposts with which to gauge the validity of a proposed allocation. In addition, as the available authority has feinted and jabbed at establishing a definitive explanation of the substantial economic effect requirement, practitioners have encountered serious difficulties in understanding the import and meaning of section 704(b)(2), identifying the various key factors to the provision, and applying the substantial economic effect test to proposed allocation agreements.[42] All this indefiniteness naturally casts doubt upon the validity of all special allocations and discourages practitioners from using this otherwise valuable tax tool in shaping business forms.

The source of all this confusion is the uncertain scope of the inquiry taken by the courts and commentators into the propriety of special allocations. The courts have traditionally taken a narrow ad hoc approach in testing the validity of a section 704 allocation, probably because substantial economic effect is normally a fact question. In contrast, commentators have viewed special allocations more broadly and frequently noted the inconsistencies between decisions under section 704 and decisions construing other sections of subchapter K. Despite this dispute over the scope and purpose of the proper inquiry, the ruling authorities have failed to supply practitioners with comprehensible guidelines to resolve the controversy over the true meaning of the substantial economic effect requirement. Thus, the uncertainty that subchapter K was designed to remedy still plagues portions of partnership taxation. A review of the case history of section 704 exposes the awkwardness of the judiciary when deciding the issue and trying to fashion a lasting

39. *Id.* at 127.
40. At the very least, substantial economic effect is the threshold question in determining the validity of a special allocation. 1 A. WILLIS, *supra* note 4, §§ 25.02-.03. *See also* Driscoll, *supra* note 8, at 424-31; Wolfen & Fossum, *supra* note 8, at 411-14.
41. Rev. Proc. 74-22, 1974-2 C.B. 6.
42. The term "substantial economic effect" is also used in other areas of the law, which adds to the confusion. *See, e.g.*, Wickard v. Filburn, 317 U.S. 111 (1942) (constitutional law).

precedent without a more ordered approach to testing the economic effect of a section 704 allocation.

The first major case testing the scope of section 704(b)(2) limitation on the right to determine by private agreement the distribution of partnership income and loss was *Smith v. Commissioner*.[43] In *Smith* two partners agreed to distribute retroactively all the income tax consequences to partner *A* as part of a dissolution agreement. Partner *A* had indicated the partnership would probably suffer a net loss and had agreed to assume that loss in return for partner *B*'s agreement to sell his capital interest for less than its face amount. At the end of the tax year when the partnership had in fact made a profit of $86,000, partner *A* tried to shift a portion of that gain to partner *B* in the partnership return, resulting in inconsistent income tax returns for the two partners. Partner *A* contended that their amended arrangement to allocate to him all the profit and loss was without substantial economic effect and, therefore, was invalid as an attempt to avoid taxes.[44] Although indirectly affirming the principle that the partnership agreement can never be used as a vehicle to escape taxes, the court mainly addressed itself to the question of retroactive allocation of business consequences. It held that the intent to avoid taxes is determined at the time the allocation agreement is made and that in this instance, all profits were properly retroactively allocated to partner *A*.[45] Thus, while the court never expressly ruled on the point, an intention to avoid taxes is evidently absent when the effect of an allocation is not known at the time of the agreement and the allocation serves a bona fide business purpose.[46]

As the obvious question in the *Smith* case concerned the entitlement of a partner to a retroactive allocation, the more subtle, underlying threshold inquiry by the court into whether the allocation had the requisite economic effect that section 704(b) demanded is easily overlooked. Nevertheless, in upholding the allocation the court implicitly endorsed the application of the substantial economic effect test to all other tax provisions in subchapter K affecting the partnership allocation agreement. This endorsement is demonstrated by the court's application of the section 704 test to the section 761 question even though the wording of section 704(a) prior to 1976 expressly limited the application of that test to section 704. At the same time, the *Smith* court implicitly held that a special, additional risk met the substantial economic effect test and would justify a special allocation.[47] The Tax Reform Act of 1976 has now codified both of these judicial implications by expressly incorporating the test itself into the statute[48] and extending the substantial economic effect test to all partnership allocations "except as otherwise provided in this 'Chapter.'"[49]

The timing of the special allocation was apparently the deciding factor in

43. 331 F.2d 298 (7th Cir. 1964).
44. *Id.* at 300. For a more complete factual picture see [1962] T.C.M. (P-H) ¶ 62,294.
45. 331 F.2d 298, 301 (7th Cir. 1964).
46. *Id.*
47. 331 F.2d 298, 301 (7th Cir. 1964).
48. HOUSE COMM. ON WAYS AND MEANS, *supra* note 9, at 125-26.
49. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 90 Stat. 1520 (the previous language had read "except as otherwise provided in this section").

Smith because of the special risk it posed. Presumably, if the partners after deciding to liquidate had waited until the net partnership result had become known, the special allocation would have been disregarded. In that situation the allocation would have been more of a capital transaction than an allocation of risk to venture capital.[50] Therefore, the holding in *Smith* is consistent with cases involving exchange of interests in a capital asset for relief from obligations to pay current maintenance and development expenses.[51] In such cases the partners, in reality, are trading an interest in an asset of known value for the discharging of currently deductible obligations. Since risk is absent from the transaction because both considerations are capable of calculation, the courts have correctly required the funding partner to capitalize a portion of the expenses.[52] Thus, the special allocation of an item must be attributable to a partner's assumption of a special capital risk and the net effect of that allocation cannot be capable of calculation at the time of the allocation.[53]

In *Jean V. Kresser*[54] the principal issue was also the nature of an allocation agreement. The taxpayer owned varying interests in two partnerships and received income from both in fixed percentages. To avoid losing an expiring net operating loss carry over,[55] partner *A* persuaded the other partners, including the taxpayer, to allocate the 1966 income to him in return for his promise to restore the income to their accounts from future profits.[56] The court refused to sustain the taxpayer's allocation on both procedural and substantive grounds, holding that the allocating partner failed to prove compliance with section 761(c) which requires the assent of all partners to a modification of the partnership agreement before it is effective.[57] In addition, the court held the allocation was merely a bookkeeping entry rather than a bona fide allocation of economic substance.[58] The court reasoned that

50. In a "capital transaction" a person *purchases* investment or business property (an asset) for the purpose of either subsequent appreciation in value or production of income but an "expense" represents the *consumption* of the economic value of an asset in the current fiscal period or the *cost* of maintaining an interest in a capital asset without extending its useful life. *Cf.* Rodman v. Commissioner, 542 F.2d 845 (2d Cir. 1976) (purchase or assignment of income).

51. The purpose of such an agreement is to relieve the vendor of a cash expense while the vendee disguises his capital outlay as what normally would qualify as currently deductible expenses. This ploy has two possible tax benefits for the vendee. First the vendee obtains a tax deferral by using the current deduction to shield his present ordinary income. Secondly, upon disposal of the capital asset, the deferred income is taxed at the lower capital gains rates to the vendee. The vendor also receives a tax break because he postpones recognition of his gain on the sale until he and the vendee finally dispose of the property to a third party.

52. *See, e.g.*, Ashworth v. United States, 71-2 U.S. Tax Cas. ¶ 9710 (S.D. Ill. 1971) (transfer of one-half interest in real property in exchange for payment of land development expenses); Herbert K. Stevens, 46 T.C. 492 (1966), *aff'd*, 388 F.2d 298 (6th Cir. 1968) (transfer of interest in race horses in exchange for an agreement to maintain and train the horses).

53. *See* note 104 *infra* and accompanying text.

54. 54 T.C. 1621 (1970).

55. I.R.C. § 172(b).

56. 54 T.C. 1621, 1625-26 (1970).

57. *Id.* at 1629-30. Section 761(c) previously provided that the partnership agreement includes modifications "which are agreed to by all the partners, or which are adopted in such manner as may be provided by the partnership agreement." But all modifications had to be made prior to the time for filing the partnership tax return. I.R.C. § 761(c). Under this tax provision, partners could retroactively allocate provided that the allocation did not violate other tax rules and regulations.

58. 54 T.C. at 1630-32. The court found no convincing evidence that all the partners ever agreed to a substantive modification of the partnership agreement. *Id.*

the partners would in effect continue to receive their fixed percentage interests in partnership income and were not risking any capital because of partner *A*'s assurance that he would repay the allocation regardless of the economic success or failure of the partnership business. Thus, the other partners were, in reality, loaning partner *A* their current deductions which partner *A* was obligated to repay. Evident in the court's opinion is an effort to penetrate the form of the transaction to discern its true substance.[59]

The economic reality of the special allocation was also viewed as determinative in *Stanley C. Orrisch*[60] where the oral partnership agreement provided that the two partners, Orrisch and Crisafi, would share profits and losses equally. By a later oral agreement Orrisch was to receive all depreciation deductions; income and loss was to continue to be divided evenly.[61] If the partnership property was sold at a taxable gain, then the depreciation deductions were to be charged back to Orrisch. This way the deducting partner, Orrisch, would report the taxable gain from the sale attributable to the earlier deductions. The only real significance of the allocation was tax deferral. One partner relinquished current depreciation deductions in exchange for relief from the tax on an equivalent amount of gain at the time of a sale.[62]

The court invalidated the special allocation. The court found that the special allocation had no effect on the dollar amount of the partners' shares of income and loss of a sale at any price because the partners contemplated an equal division of partnership profit and loss at all times.[63] From these findings the court held that the principal purpose of the allocation was tax avoidance and, thus, disallowed the allocation.[64] The court emphasized that the critical issue was who would bear the economic burden of the allocation.[65] In this case Orrisch had been receiving a 100% allocation of deduction based upon a 50% interest in the depreciable capital. Such an allocation is tax avoidance to the extent that the allocation exceeds the allocating partner's real economic burden.

A careful reading of *Orrisch* suggests the following maxims regarding special allocations: (1) A transaction must have a purpose other than tax minimization.[66] (2) Unless a party is actually bearing the economic burden of an event, he is not entitled to the special allocation.[67] (3) A final reconcilia-

59. The allocation might have been valid under the *Orrisch* doctrine (*see* notes 60-71 *infra* and accompanying text) had the modification shifted a significant economic risk to the other partner such as making the "restoration" contingent on the success of the partnership. Wolfen & Fossum, *supra* note 8, at 426-27. Similarly, the *Orrisch* allocation may have been valid had the partner receiving the deduction (Orrisch) borne the risk of loss if the property sold for less than its adjusted basis.

60. 55 T.C. 395 (1970), *aff'd*, 31 Am. Fed. Tax R.2d 1069 (9th Cir. 1973). For an alternative analysis of the case see Cowan, *supra* note 37, at A-10-12.

61. The fact that the allocation was an amendment to the original partnership agreement makes it look even more like a tax avoidance scheme.

62. 55 T.C. at 397.

63. *Id.* at 404.

64. *Id.*

65. *Id.* at 403.

66. *Accord*, Gregory v. Helvering, 293 U.S. 465 (1935) (taxpayer has a legal right to decrease his taxes, but the action taken by the taxpayer apart from the tax motive must be that which the statute intended). *See generally* McGuire, *When Will a Special Allocation Be Recognized?*, 37 J. TAX. 74, 76 (1972).

67. *See* Rev. Rul. 68-139, 1968-1 C.B. 311 (intangible drilling and development costs may

tion of tax and economic consequences does not justify a special allocation.[68] (4) For the allocation to have substantial economic effect the partners must not expect to receive the same dollar amounts from the total partnership effort that they would have received had the allocation not been made. Thus, special allocations will probably be permissible so long as potential liability exists for economic losses in light of foreseeable circumstances.[69] (5) The taxpayer must sustain the burden of proving than an allocation has substantial economic effect.[70] (6) The special allocation will be examined in light of other allocations and adjustments made by the partnership.[71]

A footnote in *Kresser*, however, suggested the possibility that the substantial economic effect test might be limited to *specific* items of partnership income and loss.[72] Although the court never faced this question directly, such a result was unlikely considering the strong language in *Orrisch* against the pretense of paper allocations, the tax avoidance language throughout the Code, and other cases where form conflicts with substance.[73] The courts have consistently held that a slavish, unreasoned adherence to the literal

be allocated to the funding partner where the agreement specifically provides that his capital contribution will pay the intangible drilling and development costs).

68. Jean V. Kresser, 54 T.C. 1621 (1970). *See generally* McKee, *Partnership Allocations in Real Estate Ventures: Crane, Kresser and Orrisch*, 30 TAX L. REV. 1, 20 (1974). This last article attempts to eliminate the practice of "*Crane* deductions" but his reasoning is untenable as long as *Crane* is applicable to real estate ventures because his article is based on two erroneous premises. His first major premise, a one-sided loan transaction between a lender and a limited partner, fails because in reality each side receives valuable consideration. Granted, the lender risks his principal (the limited partner's capital offering), but he receives interest as consideration for that risk and the limited partner's promise to repay the loan over time. In return for his interest and promise, the limited partner does not have to pay for his capital obligation out of his own funds or risk personal liability for the note. Moreover, both sides have relatively equal bargaining positions. *Id.* at 4-5.

The second erroneous premise in the McKee article lies in his statement that depreciation reduces capital. *Id.* at 11. A partner's invested capital is determined solely by his contributions and withdrawals. Since depreciation can never be "withdrawn," it can never reduce or vary those sums of his invested capital or capital at risk; the depreciation only affects the capital's current value because it represents the economic cost of using the asset. It simply is not a capital item. Thus, "capital" and "value" do not represent the same concepts. Depreciation and appreciation merely measure the present value of capital because the capital risked remains constant until recovered. Therefore, capital and depreciation are analogous to a loan arrangement consisting of a principal amount and corresponding interest rate. The interest paid or cost of money might be based on the principal amount and may even affect the absolute sum eventually recovered, but the interest paid can never serve to reduce the principal amount of the loan. Indeed, contrary to McKee's contention, "*Crane* deductions" are so firmly imbedded in the Code that such deductions will continue to be valid until modified by statute, such as the new limitations written into § 704(d) by the Tax Reform Act of 1976, even though a partner receiving the deductions may not be personally liable for all the invested capital credited to his capital basis. By his interest payments to the lender in a two-sided business transaction, the partner pays for the use of the lender's capital that is joined with other capital contributions to form the partnership capital structure. Congress, if it had intended to overrule *Crane* statutorily, could have easily done so in the Tax Reform Act of 1976 along with its other amendments, but evidently Congress elected to leave the *Crane* decision intact with regard to real estate ventures.

69. *See* Treas. Reg. § 1.704-1(b)(2) (1964). *See also* Long, *Tax Shelter in Real Estate Partnership: An Analysis of Tax Hazards That Still Exist*, 36 J. TAX. 312 (1972); Wolfen & Fossum, *supra* note 8, at 426.

70. *Compare* Jean V. Kresser, 54 T.C. 1621 (1970), *with* Leon A. Harris, Jr., 61 T.C. 770 (1974). *See also* Stanley C. Orrisch, 55 T.C. 395 (1970), *aff'd*, 31 Am. Fed. Tax. R.2d 1069 (9th Cir. 1973).

71. *See* Comment, *supra* note 30.

72. Jean V. Kresser, 54 T.C. 1621, 1631 n.5 (1970).

73. The disregard of a method of tax accounting because of tax avoidance is not unique to § 704(b)(2). *See also* I.R.C. § 269 (acquisitions made to evade or avoid income tax), § 367(a)(2) (tax avoidance in exchange with foreign corporations).

reading of the statute cannot defeat the statutory intent.[74] The question for determination in tax avoidance cases has been whether what was done, apart from the tax motive, was that which the statute intended.[75] Nevertheless, the Tax Reform Act ended such speculation by specifically providing that "an overall allocation of the tax income . . . should be subject to disallowance on the grounds of tax avoidance or evasion in the same manner as allocations of an item of income or loss."[76]

The Courts and Congress have combined on other occasions not only to change conditions but to add new conditions to the private allocation of the amount and timing of a partner's tax liability. For example, in Revenue Ruling 75-214[77] the Service ruled that payments made by the partnership to reimburse a general partner for costs of organizing the partnership and for selling the limited partnership interests were not automatically deductible by virtue of section 263. In *Jackson E. Cagle, Jr.*[78] the Tax Court similarly disallowed deductions claimed by the limited partnership for payments to the general partner for services rendered in conducting a feasibility study of a proposed office showroom facility, obtaining financing, and developing a building for the partnership. In this decision the Tax Court expressly rejected the contention that Congress, in enacting section 707(c), has intended to make the guaranteed payments to partners automatically deductible to the partnership without regard to section 162(a).[79] The House Report on the Tax Reform Act, after noting the uncertain legality of this practice, endorsed and adopted the view expressed by Revenue Ruling 75-214 and *Cagle*.[80] Thus, both the courts and Congress have demonstrated their intent to heighten their efforts to prevent taxpayers from using partnerships as a means of avoiding taxes.

Although decided prior to the Tax Reform Act of 1976, *Leon A. Harris, Jr.*[81] exemplifies the contemplated function of a section 704 allocation. In *Harris* a partnership sold at a loss an undivided ten percent interest in real estate to certain trusts. The other partners agreed to distribute the entire proceeds of the sale and allocate the entire loss on the sale to petitioner with the understanding that the loss would permanently reduce his capital account, his interest in the partnership, and his share of future profits and losses.[82]

Such an economic impact sharply distinguishes the *Harris* allocation from the *Orrisch* allocation agreement. As far as the *Orrisch* court could determine, the allocation had only a temporary economic effect because the *Orrisch* partners intended only to trade tax consequences and never intended to affect their interests in partnership revenues permanently. Since

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74. *See generally* Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935); Garlock Inc., 58 T.C. 423 (1972), *aff'd*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974). *But cf.* International Trading Co. v. Commissioner, 484 F.2d 707 (7th Cir. 1973), *rev'g* 87 T.C. 455 (1971).

75. Gregory v. Helvering, 293 U.S. 465 (1935).

76. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 15 Stat. 1520.

77. Rev. Rul. 75-214, 1975-1 C.B. 185.

78. 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976).

79. *Id.* at 88.

80. HOUSE COMM. ON WAYS AND MEANS, *supra* note 9, at 120-22.

81. 61 T.C. 770 (1974).

82. *Id.*

the special allocation in *Harris* was a bona fide transaction of economic substance which was bargained for at arm's length, the court upheld the transaction as a valid special allocation even though the desire of the petitioner to obtain an ordinary instead of a capital loss was a motivating factor in the structuring of the transaction.[83] The permanent effect of the allocation still possessed sufficient economic impact to sustain the taxpayer's burden of proof that the principal purpose of the allocation was not tax avoidance or evasion within the meaning of section 704(b)(2). Thus, *Harris* stands for the proposition that a businessman may utilize section 704 in structuring his transactions to reduce his tax liability as long as that special allocation has business validity apart from its tax consequences.[84]

As a review of existing case law demonstrates, no court has ever specified the exact indicia by which a taxpayer or another court can evaluate the economic effect of a special allocation. Rather, each decision has seemingly turned on a different consideration as it advanced its own set of criteria for judging the validity of the special allocation in question. Yet the courts have recognized that a partner is at times entitled to a disproportionate share of partnership profit or loss. Under the *Orrisch* doctrine the right to a larger share of profit or loss depends on the presence of an economic interest in the special allocation.[85] *Kresser* emphasizes the economic legitimacy of the allocation,[86] while other cases stress the relative certainty of the effects of the transaction.[87] Consequently, the judicial development of the substantial economic effect test not only is difficult to follow but is difficult to apply. In addition, the cases fail to indicate adequately the relationship of substantial economic effect to other partnership tax provisions such as adjusted basis,[88] modifications in partnership agreements,[89] or recognition of gain.[90] As a result, the issue of special allocations is still unsettled thirty-five years after the Johnson-Rabkin article,[91] twenty years after the adoption of the 1954 Internal Revenue Code, and a year after the Tax Reform Act of 1976. Surely taxpayers are entitled to know the interrelationships among the various subchapter K provisions to plan adequately their business behavior; they certainly deserve more comprehensible guidelines than are currently offered. For these reasons, the elements comprising the present substantial economic effect test should be listed and explained in order to guide the

83. *Id.* at 786.

84. The House Ways and Means Committee stated it this way: "While a certain degree of flexibility of allocations of special items and overall allocations may be desirable, the opportunities for such should be restricted to those situations where there is both a bona-fide business purpose and the lack of any significant tax avoidance." HOUSE COMM. ON WAYS AND MEANS, *supra* note 9, at 126.

85. Stanley C. Orrisch, 55 T.C. 395 (1970), *aff'd*, 31 Am. Fed. Tax. R.2d 1069 (9th Cir. 1973).

86. Jean V. Kresser, 54 T.C. 1621 (1970).

87. *See, e.g.*, Norman Rodman, 42 T.C.M. (P-H) ¶ 73,277 (1973), *aff'd in part, rev'd in part*, 542 F.2d 845 (2d Cir. 1976). *See generally* Lee & Parker, *Retroactive Allocations to New Partners: An Analysis of the Area After Rodman*, 40 J. TAX. 166 (1974).

88. I.R.C. § 752 (treatment of certain liabilities); Crane v. Commissioner, 331 U.S. 1 (1946); *see* notes 108-22 *infra* and accompanying text.

89. I.R.C. § 706; *see* notes 123-30 *infra* and accompanying text. *See also* 1 A. WILLIS, *supra* note 4, §§ 24.05-.08.

90. I.R.C. § 741.

91. Rabkin & Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942).

courts and businessmen effectively in deciding the propriety of a special allocation.

C. *Special Allocations: A New Approach to Substantial Economic Effect*

Partnership tax policy strives to balance competing interests. For example, Congress and the Service want partnerships to have the means to compete in the increasingly complex market place but are concerned about allowing the partners to escape their tax obligations.[92] Section 704(b)(2) disregards only those allocations which lack substantial economic effect, as such allocations are deemed attempts to avoid taxes.[93] Thus, the taxing authorities seem prepared to accept all economically reasonable allocations among the partners commensurate with their risk or services.

The attempts by Congress and the courts to explain the substantial economic effect requirement have failed, and the current special allocations test is unworkable. The test not only focuses too narrowly upon section 704 problems but, as presently defined, it lacks the flexibility to adapt to changing business practices and subsequent statutory developments. Therefore, in order to clarify the meaning of substantial economic effect and to insure that all economically reasonable allocations based on related business risks are sustained, while still requiring that all special allocations comply with existing tax regulations, the following two-pronged "reasonable risk test" is proposed:

1. Does the allocation have business validity apart from its tax consequences? (Does the allocation reflect the economic realities of the situation?)
2. Is the allocation reasonable under the circumstances? (Does the one who receives the special allocation fairly shoulder the economic burden or risk?)

This ordered approach to special allocations represents a synthesis of available authority and attempts to adhere to the principal considerations of existing case law and new statutory directives. Under the first prong the relevant considerations include (a) whether the allocation is the negotiated result of an arm's-length transaction,[94] (b) whether the allocation constitutes currently deductible expenses and not a disguised capital transaction[95] or an attempted income assignment,[96] (c) whether a taxpayer will realistically

92. 1 A. WILLIS, *supra* note 4, § 25.01.

93. Treas. Reg. § 1.704-1(b)(2) (1964); *see* notes 1-6 *supra* and accompanying text.

94. The most important protection of government interests will come from arm's length bargaining between partners. A. WILLIS, *supra* note 19, § 1.04. Indeed, the Code depends on the partnership agreement to control five important tax conclusions. *See* I.R.C. § 704(a) (distributive shares of partnership taxable income or loss); § 704(b) (distributive share of particular classes of income, gain, loss, deduction, or credit); § 704(c)(2) (special allocations for property contributed by a partner); § 704(c)(3) (allocations to partners for depreciation, depletion or gain or loss for undivided interests in property contributed by the partner); § 736(b)(2)(B) (characterization of payments to a retiring or deceased partner as being for his interest or good will).

95. The distinction here is whether the outlay is a purchase of an asset or the consumption of an asset. *See* notes 50-53 *supra* and accompanying text.

96. Rodman v. Commissioner, 542 F.2d 845 (2d Cir. 1976).

expose himself to greater liabilities to protect his investment,[97] and (d) whether the allocation would have been made if it were not for the tax consequences.[98] The burden is decidedly on the taxpayer to meet the conditions under the first prong of the reasonable risk test in proving the business validity of the allocation because these conditions are facts that the taxpayer can most easily prove. Once the taxpayer has affirmatively proved each of these conditions, he has demonstrated that the allocation has business validity apart from its tax consequences. Although such proof tends to rebut any administrative presumption of the Service regarding the principal purpose of the allocation in question, the taxpayer, to be assured of prevailing, must further show by positive evidence that the special allocation satisfied the reasonableness portion[99] of the reasonable risk test outlined below. Once both prongs are met, the taxpayer will have established conclusively the legitimacy of the allocation.

The conditions of reasonableness under the second prong are more susceptible to objective inquiry than the business validity portion of the reasonable risk approach. Nevertheless, the burden remains on the taxpayer to come forward to prove the reasonableness of the allocation under the circumstances.[100] To support his case for the questioned allocation, the taxpayer should show that the allocation satisfied all of the following conditions: (a) that the allocation fairly matches the economic expense of the business with a partner's capital contribution;[101] (b) that the allocation is reasonably within statutory requirements for deduction;[102] (c) that the allocation actually reflects the substantive distributions of partnership efforts and is not merely a paper allocation;[103] (d) that the effect of the allocation was not capable of calculation at the time of the making of the allocation agreement;[104] and (e) that the risk has always been associated with the

97. For example, a partner should only be able to deduct expenses beyond his capital interest if his exposure is greater than his invested capital or if the fair market value of the property securing the loan exceeds the partnership liability. A partner must have an economic incentive to risk his capital but the allocation must be based on foreseeable circumstances and the assumptions underlying the allocation must in themselves be reasonable. This condition attempts to limit a partner's maximum allocation to his *real* risk or risk reflected in his interest rate.

98. 1 A. WILLIS, *supra* note 4, § 25.01.

99. I.R.C. § 162 limits deductions to ordinary and necessary allowances although reasonable allowances may vary according to the nature of the item such as depreciation and the situation such as a small business bonus depreciation.

100. Since the Service relies on the partnership agreement for so many important tax conclusions (*see* note 94 *supra*), a fair reading of § 704 might include the implicit presumption that the partnership allocation agreement is valid and reasonable.

101. The economic expense does not necessarily have to be a cash expense but it must represent the consumption of some business asset.

102. The allocation may even be unreasonable if the Code sanctions such a result. For example, the Code allows accelerated depreciation, bonus depreciation for small businessmen, and investment credits, although these tax expenses actually exceed the economic cost of the business asset. Such deductions are frequently said to be a matter of legislative grace. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943).

103. This condition reflects the holding in *Kresser* and *Orrisch* where the partners never really contemplated that the partner receiving the allocation would ever actually bear the economic risk. It was merely a bookkeeping entry. No distinct revenue or loss was associated with that partner's capital contribution.

104. This condition simply requires that some risk be present. *See* notes 50-53 *supra* and accompanying text. The effect of a valid allocation must be contingent upon the outcome of a business venture instead of being calculable at the time the allocation agreement is made. *See also* Smith v. Commissioner, 331 F.2d 298 (7th Cir. 1964).

allocation.[105] The net effect of the reasonableness prong is to assure the Service that any reduction in tax liability will not result in any significant tax avoidance because the allocation complies with all applicable Code provisions and case law. Thus, the special allocation will be disregarded under the reasonable risk test unless the allocation is sufficiently connected with a partner's particular contribution to the success of the partnership according to both the market place (business validity) and the Internal Revenue Code (reasonableness).

The reasonable risk test essentially blends the economic effect test with the tax avoidance test. It demands that an allocation have business validity apart from its tax consequences and that the allocation be a reasonable attribution economically borne by the taxpayer. The validity of an allocation is examined objectively not only from within the partnership but outside the partnership in the business world. In addition, the reasonable risk test seeks to apply a single test in allocation controversies based on the relevant tax premises of subchapter K.[106] Furthermore, it avoids subtle distinctions between income and loss or even the form of the allocation in order to concentrate on certain relevant conditions. Thus, the reasonable risk test refines the substantial economic effect test from a nebulous standard into a manageable inquiry into the economic reasonableness of the allocation among the partners. Moreover, the reasonable risk test provides a more comprehensible means of resolving taxpayers' questions as well as reflecting legislative concern for flexibility, simplicity, and equity in partnership taxation.[107]

II. CRANE, RODMAN, AND ORRISCH RECONSIDERED

A. *Crane: The Inadvertent Origin of Tax Shelters*

The source of much of the abuse of the special allocation privilege stems from the subsequent judicial exaggeration of the initial *Crane* doctrine. In *Crane v. Commissioner*[108] the taxpayer received mortgaged property from her deceased husband's estate with a fair market value of $262,042.50.

105. As in United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965), *Kresser*, and *Orrisch*, a final reconciliation of tax consequences with business allocations will not satisfy the reasonable risk test. To remain valid, an allocation must always be associated with that partner's special partnership contribution or risk.

106. *See* notes 108-130 *infra* and accompanying text.

107. When the Texas Supreme Court was confronted with the issue of a special allocation in Park Cities Corp. v. Byrd, 534 S.W.2d 668 (Tex. 1975), the court considered only the financial benefits to the general partner receiving the allocations and ignored the more important question of who was actually bearing the economic burden of the deduction. The court based its reversal instead on the erroneous idea that a debit balance in a partner's capital account constituted an asset of the partnership and held that the general partner must contribute the amount of that debit balance back to the partnership although the debit balance represented solely depreciation deductions and the general partner had never taken any monies out of the partnership. *Id.* at 674. The general partner had only used the allocation of deductions (on property she was risking) to reduce her other income. Thus, the Texas Supreme Court allowed a limited partner to receive hundreds of thousands of dollars for a mere $100 financial risk. This holding violates basic accounting precepts as well as the economic burden teachings of the substantial economic effect test. *See also* 1 A. WILLIS, *supra* note 4, § 25.11.

108. 331 U.S. 1 (1946). For a good discussion of the limits of the gross basis concept of *Crane* see Adams, *Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972).

Although the taxpayer operated the property for seven years she was unable either to reduce the principal or to pay the accrued interest. She then disposed of the property for a net cash payment of $2500 which represented the difference between the mortgage liability and the fair market value of the property. The taxpayer contended this cash sum, her equity in the property, constituted her only gain.[109]

The Commissioner disagreed. He noted that the building was worth $207,042.50[110] at the time she received it. In the ensuing years she had claimed depreciation deductions of $28,045.10, leaving an adjusted basis of $178,997.40. The Commissioner contended that the selling price should fairly include not only the cash payment but also the principal amount of the mortgage ($257,500.00) of which $203,028.85 was attributable to the building. Thus, the Commissioner calculated that the taxpayer had an ordinary gain of $24,031.45 from the sale of the building.[111] The court justifiably sustained the Commissioner's findings.[112] To decide otherwise would be to allow a taxpayer to take current deductions without adjusting her tax basis in the property. This lack of adjustment would distort the computation of gain or loss when the taxpayer finally disposed of the property in question. In addition, it would ignore the economic reality of the situation: since the taxpayer had property with a fair market value exceeding her mortgage, she would normally have protected her investment from a mortgage foreclosure. Common business sense alone would have demanded that the taxpayer sell the property before foreclosure rather than allowing the bank to sell the foreclosed property at a forced sale at a lesser price and impose liability on the taxpayer for any difference between the mortgage note (plus selling expenses) and the foreclosure proceeds. For this reason, *Crane* should be limited to the fact situation on which it was decided when the fair market value of the mortgaged property exceeds the face amount of the mortgage note.

Relying on *Crane*, other court decisions have erroneously allowed taxpayers to include in their tax basis the liabilities of the partnership regardless of the economic realities of the situation.[113] Thus, the *Crane* rationale is used to justify *Crane* deductions[114] when taxpayers receive current deductions which the taxpayers do not economically bear on leveraged real estate. Such a rule offends the original *Crane* rationale that stressed the principle that the tax accounting should reflect the economic reality of the event. Therefore, the holding of *Crane* should be limited, as one of its footnotes suggests,[115] to investments where the fair market value of the property

109. 331 U.S. 1, 4 (1946).

110. *Id.*

111. *Id.* at 4-5. The $24,031.45 represents depreciation recapture under § 1250 for depreciable real property.

112. *Id.* at 14. Taxable property includes the physical property or the ownership rights and not merely the owner's equity. In this case, taxpayer invoked the benefits of the depreciation rules for income tax purposes but was unwilling to reduce her basis in the property by the amount of the depreciation deduction in an effort to avoid the depreciation recapture rules.

113. *See, e.g.*, Parker v. Delaney, 176 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); Manuel D. Mayerson, 47 T.C. 340 (1966).

114. McKee, *supra* note 68, at 6.

115. 331 U.S. 1, 14 n.37 (1946). *See also* McGuire, *supra* note 66, at 75; McKee, *supra* note 68, at 5. For a discussion of the consequences when this is not the case see Adams, *supra* note

exceeds the adjusted basis. Only in those situations can a taxpayer reasonably include the liabilities in his adjusted tax basis and claim the related deductions. The determinative test should be whether the taxpayer has a legitimate economic incentive to protect the mortgaged property from foreclosure. The *Crane* rule, however, has become so embedded in the tax law that only an amendment to the Code could change it, and Congress in all its reform did nothing in that respect.

A more compelling reason to limit the *Crane* doctrine is the commonsense notion that a decision under a code that did not even recognize special allocations should not be used to defeat or unduly circumscribe later statutory developments. Arguably, Congress has sanctioned much of the *Crane* doctrine in Code sections 752 and 704(d) which allow a partner to include in his basis for non-mineral real property the liabilities of the partnership even for non-recourse loans and regardless of the true fair market value of the securing property.[116] This fuzzy argument, however, ignores the tax avoidance policy found in section 704(b)(2) and other sections of the Code.[117] Moreover, although the previous Regulations did not directly address the problem of leveraged real estate, and the present section 704(d) specifically excepts most real property,[118] the basic policy of the Service seems clear: the economic substance of the transaction rather than its form should be determinative.[119] Since the Service will not tolerate any separation of the tax and economic consequences, the Service, to be consistent, should also refuse to permit *Crane* deductions,[120] even though the separation is ultimately reconciled.

Certainly, a *Crane* deduction could not be sustained under the reasonable risk test as long as the limited partner or debtor has no personal liability and the lender actually bears the economic risk.[121] In fact, unless the deduction is a bona fide risk currently borne by taxpayer, the allocation is unreasonable under the reasonable risk test even though the allocation may have been negotiated for in an arm's-length transaction and is otherwise within guidelines for statutory deductions. The interpretation of substantial economic effect in *Orrisch* and the legislative attitude reported in committee studies and in the recent amendments to the Code support this contention.[122] A partner's adjusted tax basis must reflect economic reality.

B. RODMAN AND THE LEGISLATIVE PREROGATIVE

In *Rodman v. Commissioner*[123] a new partner was admitted near year-end

108; McKee, *The Real Estate Tax Shelter: A Computerized Exposé*, 57 VA. L. REV. 521 (1971); Perry, *supra* note 108.

116. I.R.C. § 752. For an application of the rule without discussion of its reasonableness see Curtis W. Kingbay, 46 T.C. 147 (1966). *See generally* Saunders, *Basis and Allocation Problems in Dealing with Limited Partnership*, 23 TUL. TAX. INST. 182 (1974).

117. *See* notes 73-75 *supra* and accompanying text.

118. Treas. Reg. § 1.704-1(b)(2), exs. (1)-(5) (1964); I.R.C. § 704(d).

119. *See generally* Kaster, *Real Estate Limited Partnerships Special Tax Allocation*, 31 N.Y.U. INST. FED. TAX. 1799, 1804-06 (1973).

120. *See* McKee, *supra* note 68, at 6.

121. *See* notes 73-75 *supra* and accompanying text.

122. *See* notes 132-41 *infra* and accompanying text.

123. 542 F.2d 845 (2d Cir. 1976). *Rodman* is doubtful precedent because both the taxpayer and the Service have switched their legal positions several times. In addition, *Rodman* should

and allocated retroactively a full year's interest in partnership income and loss. The partnership also allocated a portion of the gain to the outgoing partner. Nevertheless, the tax court upheld the allocation as a valid modification under section 761(c).[124] This decision is not surprising considering the Code's reliance on arm's-length negotiations and many of the entity concepts of partnership taxation prevalent in subchapter K. Yet the Second Circuit reversed *Rodman* (after both taxpayer and the Service had shifted their legal positions several times) principally because the court believed the retroactive allocation had violated the well established prohibition against one taxpayer's assigning income to another.[125] Thus, *Rodman* and its subsequent legal history are significant because they illustrate the fact that Congress can, at any time, revoke the method of computing partnership distributions simply by amending the Code. Similarly, a court can abrogate one tax doctrine by superimposing another tax doctrine on top of the lesser doctrine.

If a court had used the reasonable risk test to test the *Rodman* allocation, that court would probably have upheld the allocation, at least until the recent amendments.[126] The first prong of the reasonable risk test was satisfied because the transaction was negotiated, the allocations were necessary to attract the new partner's venture capital, and the tax accounting did not offend generally accepted accounting principles for cash basis partnerships operating under the going concern theory.[127] The second prong was also met because the person receiving the allocation is actually bearing the related economic burden, the amount of the gain or loss was not precisely known at the time the new partner entered, and the modification of the partnership agreement complied with the requirements of section 761(c).[128]

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be distinguished factually from *Smith*. *Smith* involved a partnership liquidation, the effect of the allocation was not known at the time of the agreement, and the partners had an inconsistency between their informational returns and their individual returns, while in *Rodman* a new partner was being admitted after the partnership results were already known. The *Rodman* court recognized this factual distinction between buying existing interests capable of calculation in an existing partnership from the more economically contingent fact situation in *Smith*. *Id.* at 851, 857; *see* note 95 *supra* and accompanying text; note 130 *infra* and accompanying text.

124. 542 F.2d at 857-58. *Compare* Halperin & Tucker, *Tax Consequences of Operating Low Income Housing (FHA 236) Programs*, 36 J. TAX. 80, 82-83 (1972), *with* Wolfen & Fossum, *supra* note 8, at 429-30.

125. 542 F.2d 845, 857 (2d Cir. 1976). The court's decision also rested on its interpretation of § 706(c)(2)(B). The court concluded that Norman Rodman could not retroactively allocate under § 706(c)(2)(B) because he had no interest to allocate prior to Nov. 6, 1956, the time he was admitted to the partnership. *Id.* at 858.

126. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 90 Stat. 1548. The provision now provides that income and loss will be allocable to a partner only for the portion of the year that he was a member of the partnership either based on a daily determination or upon a segment system.

127. G. WELCH, C. ZLATKOVICH & J. WHITE, INTERMEDIATE ACCOUNTING (1972). The going concern or continuity assumption implies:

> indefinite continuance of the enterprise or an accounting entity, that is, that the business is not expected to liquidate in the foreseeable future. The assumption does not imply that accountancy assumes permanent continuance; rather there is a presumption of stability and continuity for a period of time sufficient to carry out contemplated operations, contracts, and commitments. This concept established the rationale of an accounting on a nonliquidation basis, and thus provides the theoretical foundation for the many of the valuation and allocations common in accounting.

Id. at 8.

128. I.R.C. § 761(c) formerly read:

> A partnership agreement includes any modifications of the partnership agree-

As Congress has regulated the statutory allocation of non-cash expenses, Congress has the same power to regulate cash expenses of a partnership. Indeed, Congress has recently decided that an allocation, to be reasonable, must be apportioned according to the time a partner actually has spent in the partnership either on a daily basis or on a segment basis.[129] Therefore, the reasonable risk test must remain flexible in order to respond to changes in case law and statutory requirements.

The *Rodman* problem arose partly because of an inherent conflict within subchapter K between the entity and aggregate theories of partnerships.[130] The special allocation reflects the aggregate theory of partnerships in which the partners are treated as having individual rights in each item of income and loss. The retroactive allocation, however, reflects the entity concept. The change to apportionment of income and loss adopts the aggregate approach to partnerships for both allocations and admissions of partners since the individual partner's rights now accrue over the fiscal year rather than vesting at year end in those partners who at that time belong to the partnership entity. Consequently, the reasonable risk test remains appropriate for testing the propriety of an allocation; only the conditions which would support an allocation have changed.

C. *Orrisch: The Foundation of Legislative Reform*

Commentators and subsequent court opinions as well as the reasonable risk test[131] have basically adhered to the *Orrisch*[132] principles when examining the validity of a special allocation. Nevertheless, the *Orrisch* doctrine should be reviewed in light of recent congressional activity to determine if it is still good law. Fortunately, Congress has based much of its reform on the framework of the *Orrisch* decision. In fact, according to the House report on the Tax Reform Act of 1976 Congress seems not only to have included the *Orrisch* doctrine in its amendments but to have imposed an even more objective standard for the recognition of special allocations.[133] Indeed, Congress seems intent on a closer matching of economic expenses with the corresponding economic risk or contribution.[134] More specifically, Congress has apparently decided that *Rodman* allocations will no longer be acceptable because a partner entering after the beginning of the fiscal year is not really incurring any risk or shouldering any economic burden for the time he was

ment made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

129. *See* CONFERENCE REPORT ON TAX REFORM ACT OF 1976 (Sept. 13, 1976), *reprinted in* 63 FED. TAX REP. (CCH) 399, 422-23 (Sept. 16, 1976) (No. 42) [hereinafter cited as CONFERENCE REPORT].

130. 1 A. WILLIS, *supra* note 4, §§ 2.01-.04. The Code adopts the theoretically preferable result rather than adhering strictly to a single concept of partnership taxation. I.R.C. § 704(c)(2). Nevertheless, *Rodman* has been extinguished by § 213(c) of the Tax Reform Act of 1976.

131. *See* notes 94-105 *supra* and accompanying text.

132. Stanley C. Orrisch, 55 T.C. 395 (1970), *aff'd*, 31 Am. Fed. Tax. R.2d 1069 (9th Cir. 1973).

133. *Compare id.* at 401, 403, *with* HOUSE WAYS AND MEANS COMM., *supra* note 9, at 126; *cf.* I.R.C. § 465 (at risk).

134. *See* notes 93-108 *supra* and accompanying text.

not a member of the firm.[135]

Another partnership reform is the congressional decision that special allocations must be allocated according to the partnership agreement or, in the event of a disallowance of a special allocation, reallocated in accordance with the partner's interests in the partnership.[136] This rule is not applicable, however, if the partner receiving the special allocation can establish that there is a business purpose for allocating the loss or item, and no significant tax avoidance results from the allocation.[137] Therefore, under either these new rules or the *Orrisch* doctrine mere trading of partnership tax consequences between high and low bracket taxpayers certainly will not be sufficient for the special allocation to qualify for the exception. The allocation must be assigned on the basis of some added risk or economic burden which is associated with that partner's contribution.

In its determination of what is a valid special allocation the *Orrisch* opinion suggests that, beyond having substantial economic effect, a special allocation must also have a reasonable business purpose.[138] Such a business purpose, according to *Orrisch*, is one that "reflects normal business considerations [and is not] designed primarily to minimize the overall tax liabilities of the partners."[139] *Orrisch* also indicates that the partner receiving the allocation must actually "bear the economic burden of [the allocation]."[140] Thus, in adding the business purpose to section 704 Congress has codified much of the *Orrisch* analysis into the partnership tax provisions. Notably, the three main principles of *Orrisch* (business validity, economic effect beyond the tax consequences, and reasonableness) are incorporated not only in the Tax Reform Act of 1976 but also in the reasonable risk test.[141]

III. CONCLUSION

Despite a paucity of legislative guidance and litigation on the issue, the judiciary has struggled to define, interpret, and apply consistently the special allocation rules. The essence of a special allocation is that one partner sometimes deserves a greater share in particular partnership results for his proportionately greater efforts. The difficulty lies in determining the circumstances which warrant such an allocation. The current substantial economic effect test, which narrowly focuses only on the allocation issue and ignores other tax concepts, is so vague that no one knows its precise meaning. Since Congress has again failed to delineate the meaning of substantial economic effect, the courts should decipher that test's elements in order to structure an inquiry that weighs all relevant tax considerations in deciding the merits of a special allocation. For this reason, this Comment proposes the reasonable risk test to help the courts structure such a test. It

135. Congress also intends to limit the availability of artificial losses resulting from *Crane* deductions. *See* CONFERENCE REPORT, *supra* note 129.
136. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 90 Stat. 1548.
137. *Id. See also* CONFERENCE REPORT, *supra* note 129.
138. 55 T.C. 395, 401 (1970), *aff'd*, 31 Am. Fed. Tax. R.2d 1069 (9th Cir. 1973).
139. *Id.*
140. *Id.* at 403.
141. *Compare* notes 66-71 *supra* and accompanying text *with* notes 94-107 *supra* and accompanying text.

includes all the relevant tax policies of subchapter K to aid in resolving disputed and complex tax questions where multiple tax provisions are involved. At the same time it seeks to break down the substantial economic effect requirement into more comprehensible terms in order to analyze the true economic nature of an allocation. Theoretically, under the reasonable risk test special allocations of deductions arising from partnership provisions will be recognized only where the expenditure is funded by a partner's contribution and where the deduction is charged against the contributing partner's capital account without certainty of reimbursement. The reasonable risk test also requires that special allocations objectively reflect a partner's special contribution to the profitable operation of the business without offending any other statutory regulation. Thus, the reasonable risk test is entirely consonant with recent court decisions, legislative action, and commentator analysis.